**Oral Testimony for June 14 hearing of House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises**

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With the NASDAQ cut in half from 2000, and Internet stocks trading for pennies on the dollar, many Americans are asking themselves, "What happened?"

How come no major securities house predicted you might lose half your dough on the NASDAQ in less than a year? Or almost all your money on an eToys, Priceline or iVillage?

It reminds me of that old joke from 1970s, made fresh again by recent events: How do you end up with a million bucks on Wall Street? Start off with $2 million.

What the general investing public doesn't realize yet – though it is catching on – is that Wall Street research has become hopelessly corrupt.

Today's so-called analysts are more akin to lawyers in court – they regard their job as one of advocacy, to make the best case why a stock is a terrific buy. Ask an analyst if what he or she is doing is dishonest, and they will answer that you "don't understand their job description."

What happened to analysis? Why does a "sell signal" make up less than one percent of analyst recommendations?

The answer lies in the way Wall Street make money today, compared with 1975.

Twenty-five years ago, Wall Street made money on ordinary, retail trading commissions, which were fixed by regulation. That environment – something of a cross between Shangri-La and Fat City – made Wall Street a clubby place of almost assured profits.

The prized customer was a wealthy individual or family that liked to trade stocks, and the prize employee the stockbroker with a "good book" of business.

But the SEC erased fixed trading rates in 1975, an action then fought tooth-and-nail by the industry, which wanted no part of free enterprise and competition. In the years since, if inflation is taken into account, trading commission have fallen to a penny on the dollar, if one looks at thrifty investor using a discount online brokerage.

For the securities firms, the downward plummet of trading rates raised a serious, serious problem. How do we make lots of money, like we all came to Wall Street for?

Wall Street, after 1975, had to come up with a new way to make lots of money, and they found it, happily for them, in their own corporate finance departments, also known as investment banking.

Investment banking is the business of underwriting initial public offerings of stock, or secondary offerings, bond underwriting, or advising companies on mergers and acquisitions.

Too, increasingly, brokerages have moved upstream in the financing cycle of companies, often providing private equity, also called venture capital, to a company before they take it public.

This can be extremely lucrative. CIBC Oppenheimer, (now CIBC World Markets) invested $30 million in private into Global Crossing Ltd. the telecom giant. After the company went public, and the stock surged, that stake became worth $4.3 billion. And Goldman Sachs invested $36 million in private equity, or stock, in StorageNetworks Inc., a stake which became worth $1.6 billion after Goldman took StorageNetworks public.

Some quick numbers to illustrate the changing nature of Wall Street. In 1974, the US securities industry underwrote $42 billion worth of stocks and bonds. In 1999, the industry underwrote $2.24 trillion, more than 50 times the pre-1975 level.

Trading commissions made up more than 60 percent of industry revenues before 1975, but today make up less than than 16 percent, a fraction shrinking every year.

The big simple story is this: Wall Street makes it money in investment banking, not on retail trading commissions.

With this change came a change of who held power in a brokerage. In days of yore, – as quaint as it may seem today – the stockbroker with his book of business, was the power employee within a brokerage. Sometimes they were referred to a "customer's men." When an analyst wrote a report, he looked over his shoulder at the customer's men, who would hold him accountable.

Things have changed, Today, analysts look over their shoulders at investment banking and trading departments, the new profit centers.

The results of this switch in loyalties are obvious to all within the industry, so much so that brokerage analysts are referred to, often dismissively, as "sell-side" analyst. Perhaps not surprisingly, numerous industry and academic studies have found that analyst recommendations, as a group, underperform the market. Investors would be better off tossing darts at a Wall Street Journal than following analyst recommendations.
Though the role of analyst has changed dramatically in the last 25 years, their regulatory environment is little changed from 1975 or even 1945. Analysts have safe harbor under the law, even to the extent that they can tell their larger clients that a stock is really a dog, while keeping the "buy": signal on for the public. That is entirely legal. It is even legal for a analyst to tell their trading departments that a "buy" signal will be out on morrow. If the analyst is influential, the trading department can bulk up on the stock, and then sell into retail demand generated by the buy signal, all legal. Brokerages call this "building inventory to satisfy demand. Just servicing our customers." Others might call that a license to print money.

What is disturbing in the last 25 years is to see many practices once limited to regional and one-branch brokerage shops, the so-called schlock shops, become commonplace on Wall Street Proper, if you will. In particular, when a brokerage finances a company before and IPO, and then has an analyst issue a "buy" recommendation, it is mimicking practices commonplace Off Wall Street for generations.

Solutions:

- Increase the budget of the SEC for all enforcement actions, and beef up the US Attorney's Office for securities industry prosecutions.
- Require that brokerages create a uniform standard for rating analyst the accuracy of recommendations, and that analyst "batting averages," if you will, be constantly published on an industry website, maintained by the National Association of Securities Dealers.
- In the 1930s, the SEC examined whether brokerage should have both underwriting and retail trading operations under one roof. It may be time to reexamine that situation.
- Care and feeding of short traders. In a nutshell, allow short traders to have contracts specifying terms for returning borrowed shares. Short traders can be a tonic on the market.
- Better mandatory disclosure of analyst conflicts of interest in both broadcast and print media.